

THE USE OF FINANCIAL INSTRUMENTS FOR ENTERPRISE FINANCING IN LATVIA

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ABSTRACT

Latvia has developed financial market instruments model that complies with European Union requirements and that could be used by companies for borrowing as a financing alternative. However, the main factor behind the low development of debt securities market is the unfavourable tax legislation towards debt securities, as enterprises can not write down all interest payments for attracted means, but for loans granted by credit institutions it is allowed. In addition to that, the preparation of financial instruments and their placement on the secondary market is a more expensive way of attracting resources, where in the case of small issues (up to 1 million LVL) the Riga Stock Exchange costs can add up to 60-70% of all costs for the resources attracted.

Latvian enterprises for the attraction of capital resources use loans 84% of volume, capital securities 13% of volume and debt securities 3% of volume, thus the Latvian enterprises become fully dependent from loan givers, as the number of banks and their capacity is limited. The state and municipal enterprises can attract capital resources on the financial instruments market, but do not use this opportunity.

The situation is different with municipalities. Latvia is the only EU country that has not ratified points 8. and 9. of the European municipality charter on free and unlimited municipality participation in the financial capital markets, consequently, Latvian municipalities have not done a single issue. The borrowing and guarantee issue of Latvian municipalities is limited by the law "On municipality budgets", although municipalities and their enterprises are vital parts of regional development. In Estonia municipalities have done several securities issues for the cities of Tallinn, Tartu and Parnu. Also large enterprises with state and/or private capital have not done the attraction of resources on the financial instruments market in Latvia. In Estonia and Lithuania already several enterprises with state and/or private capital have done several security issues with different maturities and in different currencies.

In order to include publicly offered financial instruments on the regulated market (RSE), the accounting of the emitting enterprise has to conform to the international accounting standards, which creates additional costs for the enterprises, however, such demand conforms with the international norms.

According to the legislation, on the Latvian financial instruments market the issue of many multifunctional and complexly structured securities is possible, in the creation of which different terms and technologies can be used according to world practice.

In order to facilitate the development of the debt securities market the authors offer to make changes in the Riga Stock Exchange regulations to decrease the financial instruments service costs at least by 50%. RSE has lost economic gain from nonexistent market instruments.

Key words: Capital markets, attraction of financing, financing instruments

Since its inception in 1993, the securities market has experienced rapid development in Latvia, but, unfortunately, till 2005 the State and companies have not been using capital market as a source of financing, although the securities market in other countries plays a significant role in capital attraction. The majority of the stocks, which form the largest part of the listed securities, have been listed due to state privatization policy, and the enterprises have not themselves deliberately chosen such direction of development.

Latvia has developed financial market instruments model that complies with European Union requirements and that could be used by companies for borrowing as a financing alternative. However, the main factor behind the low development of debt securities market is the unfavorable tax legislation towards debt securities, as enterprises can not write down all interest payments for attracted means, but

for loans granted by credit institutions it is allowed. In addition to that, the preparation of financial instruments and their placement on the secondary market is a more expensive way of attracting resources, where in the case of small issues (up to 1 million LVL) the Riga Stock Exchange costs can add up to 60-70% of all costs for the resources attracted.

Latvian enterprises for the attraction of capital resources use loans in 84% of volume, capital securities in 13% of volume and debt securities in 3% of volume, thus the Latvian enterprises become fully dependent from loan givers, as the number of banks and their capacity is limited.

In order for the publicly offered financial instruments to be included in the regulated market (Riga Stock Exchange), the emitting enterprise accounting has to fully comply with the international accounting standards, which creates additional costs for the enterprise; however, such requirement is in

compliance with the international norms for the inclusion of securities in the regulated market.

Currently in the Latvian debt market there are only 2 enterprises (Alta Real Estate Partners and Happy Trails), which have done debt capital attraction on the market. In other cases the issues have been done by Latvian and foreign credit institutions, which adds up to 86% of all debt issues in Latvia.

Also on the stock market the situation is similar. In the last 10 years only one new stock has appeared on the regulated market, namely, SAF Tehnika, although especially on this market the biggest investor interest can be seen, as the stock market offers the biggest profit opportunity.

Latvian state and municipal enterprises can attract capital resources on the financial instruments market, but in real life these opportunities have not been used and loans have not been issued, as large enterprises with state or municipal capital have not done resource attraction on the financial instruments market. However, in Estonia and Lithuania enterprises with state or municipal shareholding have done already several security emissions with different maturities and denominated in different currencies, for example: *Lietuvos Energija AB, Mazeikiu Nafta AB, Eesti Energia AS, Eesti Telekom AS, Lietuvos Dujos AB, Lietuvos Telekomas AB, Eesti Post AS, Baltika AS, Tallink Grupp AS, Tallinna Kaubamaja AS, Endocrociniai Preparatai AB.*

With regard to municipalities themselves, Latvia is the only EU country that has not ratified the 8th subpoint of point 9 of the European municipality charter on the free and unlimited participation of municipalities in financial capital markets, thus Latvian municipalities have not done any issues. The borrowing and guarantee issue of Latvian municipalities is limited by the law "On municipality budgets", although municipalities and their enterprises are vital parts of regional development. In Estonia municipalities have done several securities issues for the cities of Tallinn, Tartu and Parnu. Also, large enterprises with state and/or private capital have not done the attraction of resources on the financial instruments market in Latvia.

Considerable work has been done to establish a securities market in Latvia. In Latvia there is in place a full-fledged financial instruments market model, compliant with the European Union requirements, as the financial market in Latvia and the EU is regulated by EC regulation No. 809/2004. In the Latvian financial instruments market, according to the legislation, it is possible to include very multifunctional and complexly structured securities, whose creation can foresee different preconditions and technologies according to the world practice. However, in Latvia there are no securitized asset financial instruments

on the market, although, for example, in Russia in 2005 such securities appeared on the market in the nominal volume of 4 billion USD. The Latvian legislation does not limit the emission of such securities and the possibility of their emissions is foreseen in chapter 11 of EC regulation No.809/2004.

In 1994 the Cabinet of Ministers appointed a working group to develop a securities market conception. This conception was developed by the Ministry of Finance together with Riga Stock Exchange and broker associations of commercial banks. On November 22, 1994 the Cabinet of Ministers approved the Securities market development conception, which was based on the analysis of Western European and US securities markets, research on the newly created Eastern European securities markets, as well as international standards and suggestions, which regulate the securities markets in the world. In the West two securities market conceptions are dominant - Anglo-Saxon and Continental Europe systems.

The main signs of a Continental Europe System are:

- Centralized market – centralized depository, Stock Exchange is serving as a central securities market spot;
- Brokers and banks are acting as intermediaries in the market;
- The market is accumulating the orders of buyers and sellers, executing them in a stock exchange.

Riga Stock Exchange in July 21, 1994 signed a cooperation agreement with Paris Stock Exchange and France Central Depository, which foresaw the creation of a modern and regulated Stock Exchange and depository in Latvia. In the framework of this agreement French government allocated significant financing, and French securities experts together with Riga Stock Exchange elaborated suggestions for the creation of securities market structure.

As the main components in the securities market development conception were determined:

- The creation of securities market legislation;
- Creation of securities market settlement system;
- Creation of trading system;
- Creation of securities market supervision institutions;
- Coordination of Latvian securities market with the rest of Baltic countries and other European stock markets.

In carrying out these basic propositions, a securities market has been created with all the most important institutions for effective operations:

- Financial and Capital Markets Commission has been created, which until July 1, 2001 was known as Securities Market Commission;

- Riga Stock Exchange has been formed in accordance with Continental Europe stock Exchange conception according to the so called *Order driven* securities trading model;

- The formed Latvian Central Depository is booking, accounting for and storing all Latvian securities in public circulation, as well as is ensuring settlements for securities deals.

As intermediaries in the securities market are operating only licensed intermediaries (banks, broker companies. [1]

The financial instruments market in Latvia is being regulated based on the Financial Instrument Market Law. The goal of this law is to ensure the functioning of financial instruments market, fostering:

- Protection of the rights of investors;
- Stability and reliability of the financial instruments market;
- Information availability and equal rights to all participants of the financial instruments market. [3].

The financial instruments market law is regulating the making of public offer, public turnover of securities, investment services offering, the order of licensing and supervision of securities market participants, is determining the order of financial instruments market participants licensing and supervision, their rights and obligations, as well as the responsibility for breaking the law.

The financial market instruments law is regulating only the public turnover of financial instruments, determining the primary and secondary circulation of securities [3]. This means that there is also a primary and secondary turnover of financial instruments, not regulated by the law, as the main task of the Financial Instruments market law is defending investors who invest in securities in public circulation.

We can thus conclude that there are publicly and non-publicly offered financial instruments. This means that in the case the emitted financial instrument is not being publicly offered and included into the secondary market, the primary and secondary circulation of this financial instrument from the viewpoint of legislation is not regulated. The world practice is that a large share of financial instruments is being distributed by the means of private placements, as public offer is meant for the cases when the round of potential investors is not known. However, if the range of potential investors is known, there is no need for the financial instrument emitter to pay additionally for preparing a public offer.

Similar situation is also with including the financial instrument in the regulated market in the case the owner of the financial instrument does not need high liquidity, then also in this case the emitter of the financial instrument does not have to uselessly pay for the public placement. The abovementioned

can be attributed not only to Latvia, but also to the European Union, as since July 2005 the public placement of financial instruments in the secondary turnover in Latvia is being regulated in accordance with the requirements of European Commission regulation No. 809/2004.

In order to facilitate the development of the debt securities market, the authors offer:

- To change the law „On securities market“, where enterprise payments for publicly attracted resources have to be written down in expenses, equaling it to banking loan interest payments;

- To change the law “On individual income tax“, where the income from public securities investors physical persons would not be taxed with 25% income tax, as this makes enterprise debt securities less attractive compared to state securities, mortgage securities and bank deposits, whose income is not being taxed with individual income tax and creates conditions of unequal competition.

- To make changes in the Riga Stock Exchange regulations decreasing the financial instruments service costs at least by 50%. RSE has lost economic gain from nonexistent market instruments.

- Latvia has to fully ratify the European municipality charter and to do consequent changes in the legislation allowing the Latvian municipality free and unlimited participation in Latvian and international financial markets.

- Latvian credit institutions, in analogy with Russia, have to start the issue of securitized assets, which on the Latvian securities market would create a new possibility for enterprises and securities issuers to release securities with a risk evaluated by a bank. This can significantly increase and diversify the resource base of the bank for further credit operations.

- The Latvian state (Ministries of Finance and Economics, as well as the Bank of Latvia) have to inform entrepreneurs on alternative ways of capital attraction compared to loans in the European Union (including Latvia), which will enlarge their financing opportunities and decrease their direct dependence from the influence and instability of lenders.

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